A NEW STRATEGY SEEKS TO REDUCE DRAWDOWNS OF SMALL-CAP EQUITIES

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02/02/2018

Investing with alternatives and option strategies that focus on volatility reduction may appear complicated, but new indexes have been designed to help simplify an approach with a goal of providing risk-mitigation strategies. I have demonstrated previously how the CBOE S&P 500 PutWrite Index (PUT) can provide downside protection compared to the traditional S&P 500 Index due to the index strategy, which incorporates premium income generated by selling a sequence of one-month, at-the-money, S&P 500 Index puts, whose proceeds are allocated to U.S. Treasury Bills in the index.

WisdomTree recently launched a similar put writing strategy for small caps and the Russell 2000 Index, the WisdomTree CBOE Russell 2000 PutWrite Strategy Fund (RPUT), a passive investment strategy that tracks the Cboe Russell 2000 PutWrite Index (PUTR), before fees and expenses. In this post, I highlight how PUTR historically has reduced drawdowns in a more volatile market space — i.e., domestic small caps.

PutWrite Strategy on Small Caps — i.e., the Russell 2000 Index

RPUT invests in short-duration Treasury Bills and collects premiums by selling Russell 2000 put options. The number of puts sold is chosen to ensure full collateralization. This means the strategy is 100% collateralized. In other words, the strategy employs no leverage.

In a previous introduction to the strategy, my colleague illustrated the lower volatility and down capture of the PUTR compared to the traditional Russell 2000 Index – standard deviations that were 7.95% since its inception, compared to the Russell 2000's 14.21%[1].

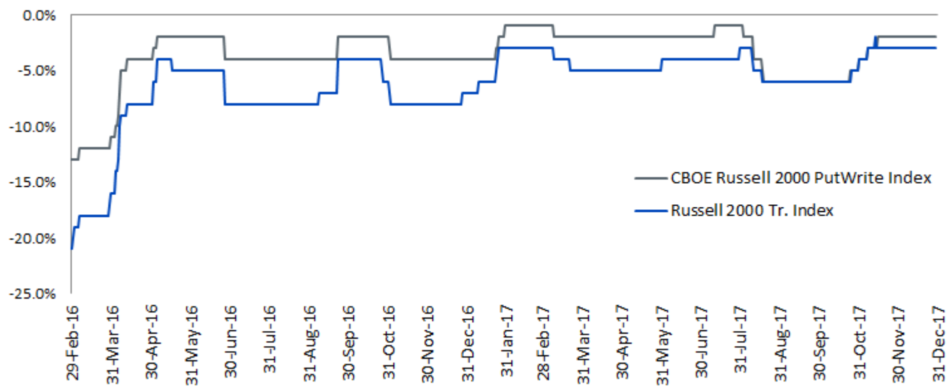
But let's go a step further in evaluating the lower-volatility approach.

Lower Drawdowns in Almost All Calendar Quarters!

Most investors prefer to look for their portfolio drawdowns over a medium-term basis. In the following example, I compare quarterly rolling drawdowns of PUTR to that of the Russell 2000 Index for the entire live history.

PUTR had a lower drawdown not only in one or two calendar quarters but essentially equal or lower drawdowns in all rolling quarters.

Rolling Quarterly Drawdowns



Sources: Bloomberg, Cboe, as of 12/31/17. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Granular Analysis of Day-to-Day Returns on Upside and Downside

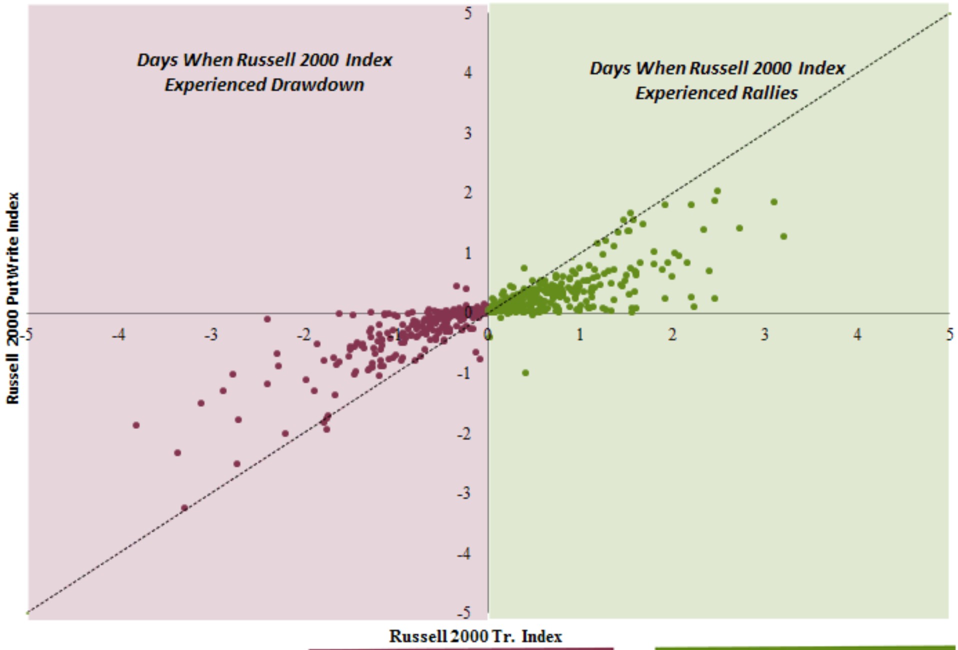
This quarterly drawdown record led us to investigate returns of PUTR and the Russell 2000 Index with even more granularity—i.e., on a daily basis under two scenarios:

- Days when the Russell 2000 Index experienced drawdowns
- Days when the Russell 2000 Index rallied

Comparing the two scenarios, the outperformance of PUTR's daily returns shows a staggering constancy on the downside.

Below is a scatter plot with returns of PUTR on the vertical axis and the Russell 2000 Index on the horizontal axis. If returns of the two indexes were exactly same for all days, all dots would line up on the 45-degree line. When a dot is above this line, PUTR had better returns than the Russell 2000 Index on that day; if a dot is below the 45-degree line, then vice versa.

Daily Returns of the Cboe Russell 2000 PutWrite Index and the Russell Tr. 2000 Index



	Daily Negative Return Stream		Daily Positive Return Stream	
	Russell 2000 Tr. Index	Cboe Russell 2000 PutWrite Index (PUTR)	Russell 2000 Tr. Index	Cboe Russell 2000 PutWrite Index (PUTR)
Mean Daily Returns (%)	-0.76	-0.46	0.74	0.30
Median Daily Returns(%)	-0.56	-0.30	0.58	0.17
Std. Dev. (Annualized)	13.18	9.93	11.65	7.07

Sources: Bloomberg, Cboe, as of 12/31/17; period covered 11/30/15–12/31/17. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Looking at the plot above, a few observations immediately stand out:

- Most of the dots in the lower left quadrant are above the 45-degree line. ***This means that most of the days when the Russell 2000 Index had negative returns, PUTR outperformed.***

    o Out of 238 days that the Russell 2000 Index had negative returns, there were just 11 days where PUTR lagged. ***Therefore, PUTR provided a consistent outperformance over 95% of the time on the downside.***[2]

- To be fair, on the opposite side, most of the days that the Russell 2000 Index rallied (top right quadrant), PUTR lagged the Russell 2000 Index.

    o Out of 287 days that Russell 2000 Index had positive returns, PUTR lagged in 259 days. Thus on the upside, PUTR lagged Russell 2000 about 90% of the time

- Finally, breaking down the return stream into days with negative returns of the Russell 2000 Index versus days with positive returns (table below the plot), in both instances PUTR had lower volatility in addition to having lower mean/median returns.

Thus, it's not just an average daily outperformance of PUTR on the downside that led to its lower quarterly drawdowns; it is the consistency in them that ensured PUTR having lower drawdowns in all rolling calendar quarters.

Conclusion

Many investors allocate to small-cap companies in strategic asset allocation models for more direct access to growth in local economies and greater long-term growth potential. However, investing in these companies typically comes with a price, which is higher volatility. This creates a dilemma for many investors who want to allocate to small caps but not take on additional volatility.

The WisdomTree CBOE Russell 2000 PutWrite Strategy Fund can potentially provide investors with a beta to small caps while still having lower volatility than a traditional small-cap benchmark. As we've experienced very robust markets over the last few years, with a lack of volatility and also extended valuations, WisdomTree believes it is a good time to consider this new fund.

[1]Source: Bloomberg, as of 12/31/17.

[2]Source: Bloomberg, as of 12/31/17.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. The Fund will invest in derivatives, including Russell 2000 Index put options ("RUT Puts"). Derivative investments can be volatile, and these investments may be less liquid than securities, and more sensitive to the effects of varied economic conditions. The value of the RUT Puts in which the Fund invests is partly based on the volatility used by market participants to price such options (i.e., implied volatility). The options values are partly based on the volatility used by dealers to price such options, so increases in the implied volatility of such options will cause the value of such options to increase, which will result in a corresponding increase in the liabilities of the Fund and a decrease in the Fund's NAV. Options may be subject to volatile swings in price influenced by changes in the value of the underlying instrument. The potential return to the Fund is limited to the amount of option premiums it receives; however, the Fund can potentially lose up to the entire strike price of each option it sells. Due to the investment strategy of the Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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You cannot invest directly in an index.

DEFINITIONS

Alternative Investment : An investment that is not one of the three traditional asset types (stocks, bonds and cash). Alternative investments typically include hedge funds, managed futures, real estate, commodities and derivatives contracts.

Option premium : The current price of any specific option contract that has yet to expire.

CBOE S&P 500 PutWrite Index (PUT) : Measures the performance of a hypothetical portfolio that sells S&P 500 Index (SPX) put options against collateralized cash reserves held in a money market account. The PUT strategy is designed to sell a sequence of one-month, at-the-money, S&P 500 Index puts and invest cash at one- and three-month Treasury Bill Rates. The number of puts sold varies from month to month but is limited so that the amount held in Treasury Bills can finance the maximum possible loss from final settlement of the SPX puts.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Put options : an option to sell assets at an agreed price on or before a particular date.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.